Case handler: Ólafur Í. Hannesson
Tel: (+32)(0)2 286 1882
e-mail: oha@eftasurv.int

Brussels, 16 February 2015
Case No: 75521
Document No: 727406

EFTA SURVEILLANCE AUTHORITY

Ágúst Karl Guðmundsson hdl.
KPMG hf.
Borgartún 27
105 Reykjavík
Iceland

Dear Mr Guðmundsson

Complaint against Iceland concerning tax rules on controlled foreign companies (CFC rules)

1 Introduction

On 6 June 2014, you lodged, on behalf of KPMG hf., a complaint with the EFTA Surveillance Authority ("the Authority") against Iceland. According to the complaint, the newly enacted Icelandic regulation No 1102/2013 ("the Regulation"), concerning taxation because of foreign ownership in low-tax areas,[1] is held to be contrary to the right of establishment in Article 31 of the EEA Agreement. In particular, the complaint holds that the requirements that companies need to fulfil in order to be considered to pursue a genuine economic activity go beyond what has been accepted by the the Court of Justice of the European Union (CJEU).

By letter of 24 June 2014, the Internal Market Affairs Directorate ("the Directorate") informed the Icelandic Government that it had received the complaint (Document No 711961).

The Directorate recalls that following the adoption of the Regulation in question, which entered into force on 11 December 2013, the Authority adopted a decision to close a previous complaint case regarding the Icelandic CFC rules (Case No 68103).

The issues raised in the complaint concern essentially the same matter as was the subject of legal proceedings before the EFTA Court in *Fred. Olsen*.[2] Therefore, the Directorate decided to put further examination of the complaint on hold pending the outcome and analysis of that case.

By email of 1 July 2014, the Directorate forwarded the complaint to the Icelandic Government.

---

[1] Reglugerð um skattlagningu vegna eignarhalds í lögaðilum á lágskattasvæðum.

[2] Joined Cases E-3/13 and E-20/13 *Fred. Olsen and Others*, Judgment of 9 July 2014, not yet reported.

On 9 July 2014, the EFTA Court delivered its judgment in the above mentioned case. In its letter of 4 November 2014 (Document No 728103), the Directorate invited the Icelandic Government to provide additional information concerning the Regulation. The Icelandic Government provided the requested information by letter dated 4 December 2014 (Document No 731855).

2 The Directorate's Assessment

The complaint concerns Article 6 of the Regulation.

In the complaint it is stated that *"[t]he new Regulation defines in Article 6 what constitutes 'genuine economic activities'... That is the Regulation stipulates what requirements need to be fulfilled in order to be considered to have 'genuine economic activities'. In order for EEA companies to be exempted from the CFC-legislation this requirement needs to be fulfilled."*

The complaint states that the requirement that a CFC is only considered to pursue a genuine economic activity when (1) *the company engages in business or commercial activities to the extent that it is considered to actively participate in the general business environment of the foreign state*, and (2) *the company has strong economic connection to the resident state of the foreign company, i.a. that it has income from its operations there*, goes beyond what can be considered to combat *"wholly artificial arrangements"*.

The complaint further states:

It is not in line with EJC broader interpretation of Art 43 of the EC Treaty to deny CFC companies access to the right of establishment for the mere reason that the activity concluded in the foreign state is auxiliary, prepatory or supportive to the core activity concluded elsewhere in the Community.

Thus, it is held:

"The wording of the regulation is in such a manner that it hinders the exercise of a parent company of its freedom of establishment by deterring it from setting up subsidiaries in other Member States."

The Directorate notes that Article 57(a) of the Act on Income Tax No 90/2003 ("the ITA") provides that the CFC rules would not apply if the non-resident companies are engaged in a genuine business activity. On 11 December 2013, the contested Regulation entered into force. The Regulation is based on paragraph 7 of Article 57(a) ITA, which was adopted on 27 March 2013, by Act No 45/2013 amending the ITA. According to this paragraph 7 of Article 57(a), the Minister of Finance and Economic Affairs is to adopt a regulation concerning the Icelandic CFC rules, mainly in order to define the term "genuine business activity".

The Directorate notes that the Regulation essentially confines the scope of the Icelandic CFC rules to real situations of tax avoidance. In line with the *Cadbury Schweppes* case law[3], it requires:

- *first*, that the CFC can be seen to be actually established in an EEA State and pursue genuine financial activities there; and
- *second*, that the relevant Icelandic authorities can verify such information by means of an international agreement. If the relevant authorities cannot demand to obtain documents from the State of establishment, the taxpayer/entity shall be provided with an opportunity to provide the necessary documentation.

It is legitimate to have recourse to presumptions of tax evasion or avoidance when activities are ostensibly being carried out in a low-tax country.[4] It must, however, be open to the taxpayer to provide contrary evidence. Such a mechanism is provided for in Article 6 of the Regulation.

In order to examine whether the requirement pursuant to Article 6 of the Regulation goes beyond what has been accepted by the CJEU, it is appropriate to take note of the preparatory works with Act No 45/2013. The preparatory works explain that the Authority has raised concerns that the definition of the term "genuine business activity" is too narrow. The rules should only cover real situations of tax avoidance. It is further stated that it is appropriate to give companies not engaged in manufacturing or selling of goods and services the opportunity to produce evidence that their activities constitute genuine business activity.

The preparatory works also state that CJEU case law has not given detailed instructions as to which conditions must be met in order for a company to qualify as being genuinely established and carrying out a genuine economic activity. It is stated that the factors in connection with the operation of a company must be assessed in light of the main purpose of the CFC rules, which is to prevent abuse of companies which are resident abroad solely in order to avoid payment of taxes. The abuse consists of a fictitious establishment in a low tax State. It is further stated that the assessment as to whether a company is established in another EEA State and whether it carries out real economic activity there, which meets the requirement of economic activity provided for in Article 31 EEA, must be based on objective factors which can be verified by the tax authorities. The Directorate notes that this appears to be a correct understanding of the CJEU case law.

As noted before, a CFC is, pursuant to Article 6 of the Regulation, considered to pursue a genuine economic activity when the company engages in business or commercial activities to the extent that it is considered to actively participate in the economic life of the State of establishment.

Article 6 of the Regulation draws up four factors which may be relevant in the assessment of whether a CFC constitutes a genuine establishment. Among other things, the relevant elements in this assessment will include (a) that the company has premises at its disposal; (b) that the company has its own employees, management, etc.; (c) that the employers and the managers of the company are competent and have been delegated the appropriate decision making powers; and (d) that the company has strong economic links with the State of establishment, *inter alia*, taking into consideration whether it has verifiable

[3] Case C-196/04 *Cadbury Schweppes* [2006] ECR I-7995.

[4] AG Opinion in Case C-196/04 *Cadbury Schweppes*, cited above, especially at para. 138 et seq.

income from its operations there. If the activities of the company are mainly carried out within a group of companies it needs to be demonstrated that its services actually create value for other companies in the group and that it is relevant for operating purposes.

In its letter of 4 December 2014, the Icelandic Government explained that these assessment criteria do not contain an exhaustive cumulative appraisal of when the CFC in question is considered genuinely established. Rather, objective factors, which may include the particular type of business involved, could lessen, or render redundant the need to assess a specific criterion.

Thus, the Directorate observes that the Regulation opens up for a case-by-case approach, based on objective criteria, to determine whether a company is genuinely established and engaged in real economic activities, and no categories of companies will automatically fall under the CFC rules.

The non-exhaustive list of assessment criteria prescribed for in Article 6 seems to comply with the test set out in the *Cadbury Schweppes* judgment, in which the CJEU stated that an establishment is to be regarded as genuine where, based on an evaluation of objective factors which are ascertainable by third parties, in particular evidence of physical existence in terms of premises, staff and equipment, it reflects economic reality, *i.e.* an actual establishment carrying on genuine economic activities and not a mere "letterbox" or "front" subsidiary.[5]

In *Fred Olsen,* the Court found that any taxation to which the beneficiaries are subjected, and which they are not afforded the possibility to have undone, constitutes a restriction on Article 31 and/or 40 EEA to the extent that such double taxation does not arise, or is undone, in a comparable internal situation.[6] When dealing with justifications, the EFTA Court maintained a similar assessment to that undertaken by the CJEU in *Cadbury Schweppes*.[7] The Court noted that the restriction must be appropriate to ensuring the attainment of the objective in question and it must not go beyond what is necessary to attain that objective.[8]

The EFTA Court stated, at paragraph 166:

"The need to prevent loss of tax revenue is not a matter of overriding general interest that would justify a restriction on a freedom guaranteed by the EEA Agreement (compare Cadbury Schweppes and Cadbury Schweppes Overseas, cited above, paragraph 49). For the purposes of preventing tax avoidance, a national measure restricting the right of establishment or the free movement of capital may be justified where it specifically targets wholly artificial arrangements which do not reflect economic reality and the sole purpose of which is to avoid the tax normally payable on the profits generated by activities carried out on the national territory (compare Case C-282/12 Itelcar, judgment of 3 October 2013, published electronically, paragraph 34, and case law cited)."

Furthermore, the Court stated at paragraph 167:

"in order for a restriction on the freedom of establishment to be justified on the ground of prevention of abusive practices, the specific objective of such a restriction must be to

[5] See *e.g.* Case C-196/04 *Cadbury Schweppes*, cited above, paragraphs 67-68.

[6] Joined Cases E-3/13 and E-20/13 *Fred Olsen* [2014], 9 July 2014, paragraphs 136-151.

[7] See Joined Cases E-3/13 and E-20/13 *Fred Olsen*, cited above, paragraphs 161-181.

[8] Joined Cases E-3/13 and E-20/13 *Fred Olsen*, cited above, paragraph 163.

prevent conduct involving the creation of wholly artificial arrangements which do not reflect economic reality, with a view to escaping the tax normally due on the profits generated by activities carried out on national territory."

In *Fred Olsen,* the EFTA Court upheld the requirements as formulated under the Norwegian rules. The Court, however, emphasised that the CFC rules cannot be applied if the establishment is genuine, taking account of the "economic reality in the State of establishment that can be certified on the basis of objective and verifiable elements."[9] Such objective elements may include the particular type of business involved, which may lessen, or render redundant, the need for the presence of premises, staff and equipment to be demonstrated in the State of establishment.[10]

The complaint also states that a requirement that the company must have strong economic connection to the resident state of the foreign company, i.e. that it has income from its operations there, goes beyond what has been accepted by the CJEU as legitimate restrictions to the freedom of establishment.

In its letter of 4 December 2014, the Icelandic Government stated that *"the concept strong economic links does also cover businesses which solely deal with business investment given that they produce evidence that their activity is of real economic activity."* The Directorate observes that this criterion (strong economic connection to the resident state) would seem to revolve, inter alia, around the question of whether the activities of a company accumulate income. Assessing whether a CFC has the ability to generate revenue in its operations could potentially be of importance for the purposes of determining whether a business is genuinely established in a given jurisdiction.

However, as stated in the Icelandic Government's letter of 4 December 2014, *"Points a.-d. of Paragraph 1 Article 6 of the Regulation are considered, amongst other things, when assessing whether a CFC participates in a real economic activity. These Points are listed as examples and do not necessarily have to be fulfilled in order for a CFC to be considered participating in a real economic activity."* Thus, *"[i]t is not self-evident that economic activities that do not result in income from the company's operations would be excluded from the definition of real economic activity. Companies that are engaged in activities that result in costs alone would be given the opportunity to produce evidence that their activity is of real economic activity."*

This seems to be in line with the EFTA Court's judgment in Fred Olsen, which held that CFC rules cannot be applied if the establishment is genuine, taking account of the economic realities of the situation – *"objective factors which are ascertainable by third parties."*[11]

The Icelandic Government further stated that *"Paragraph 1 Article 6 of the Regulation needs to be examined in connection with Paragraph 3 Article 6 and in this examination the same views apply as in the Cadbury Schweppes judgment before the Court of Justice and Fred Olsen case before the EFTA Court mainly that a CFC can demonstrate an actual establishment carrying on genuine economic activities and not a mere "letterbox" or "front" subsidiary* [...]*"*

---

[9] Joined Cases E-3/13 and E-20/13 *Fred Olsen,* cited above, paragraph 176.
[10] Joined Cases E-3/13 and E-20/13 *Fred Olsen,* cited above, paragraph 177.
[11] Joined Cases E-3/13 and E-20/13 *Fred Olsen,* cited above, paragraph 181.

EFTA SURVEILLANCE AUTHORITY

The Directorate considers, in particular in light of the Icelandic Government's statements, concerning the concrete application of the CFC rules, that there is little doubt that the Icelandic CFC rules are in line with the requirements established by EEA law. They pursue a legitimate objective, i.e. the prevention of tax avoidance through the use of "wholly artificial arrangements" involving CFCs. They are proportionate and do not go further than what is necessary in the circumstances. They do not create a general presumption of tax evasion. They rather only create presumptions in cases which involve 'low tax' jurisdictions, as permitted by *Cadbury Schweppes*. Further, they provide for any putative presumption of fictitious establishment to be rebutted upon the presentation of credible evidence by the firm in question. Therefore, while such rules may, *inter alia,* restrict the freedom of establishment within the meaning of Article 31 EEA, such a restriction is justified.

In light of this conclusion, the Directorate intends to propose that the Authority close the case. Before this proposal is made, you are invited to submit your observations on the above assessment by ***16 March 2015.*** You are also invited to present any new information that might be relevant for the reappraisal of the case by the same date.

Yours sincerely,

Ólafur Jóhannes Einarsson
Director
Internal Market Affairs Directorate